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SUBJECT: IRAN'S REFORM-RESISTANT ECONOMY

REF: RPO 174; RPO 168

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REASON: 1.4 (b), (d)

11. (S/NF) Summary: As economic issues rise to the top of the agenda in Iran's presidential campaigns, the range of the policy debate on economic issues remains narrow and is essentially limited to which candidate can better manage Iran's government dominated economy. Recent examples of currency reforms and private sector initiatives being undermined by the IRIG illustrate the limits of reform initiatives, even if there is political will, and the disconnection between rhetoric and practice. The experiences of our contacts illustrate that even if economic conditions lead to Ahmadinejad's defeat in June, significant reforms to Iran's economy are unlikely in the near term. End Summary.

The State's Not-So-Hidden Hand

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12. (S/NF) The political struggle in the Majles over President Ahmadinejad's subsidy reforms in March and the campaigning for June's presidential election have placed economic issues at the top of Iran's political agenda. However, the range of debate on economic policy is narrow, as Dr. Hooshang Amirahmadi, president of the American Iranian Council, told an oil and gas conference in Dubai on April 21. Amirahmadi described all three of the major declared candidates -- Ahmadinejad, Mir Hossein Mousavi, and Mehdi Karroubi -- as status quo candidates on economic policy, committed to maintaining the government's role in the economy but singling out Mousavi as a more competent manager. For example, one of reformist candidate Karroubi's proposals, to distribute shares of Iran's oil wealth directly to the people (ref a), is an echo of Ahmadinejad's 2005 rhetoric to put Iran's oil wealth on Iranians' dinner tables and to distribute "justice shares" of state-owned enterprises to the people.

13. (S/NF) More broadly, the powerful conservative forces that dealt Ahmadinejad setbacks in the Majles last month (ref b), who have not coalesced behind a candidate at this stage, simply favor strict adherence to Iran's five- and 20-year development plans and a restoration of the vital role of the Management and Planning Organization (MPO) in the economy, according to several IRPO academic contacts and reports in the Iranian press. Moreover, the dividing line between them and Ahmadinejad is not

over the degree of state control. Rather, Ahmadinejad's policies have been to maintain robust state involvement in the economy, but through less transparent structures like the Office of the President and the IRGC, and with an emphasis on redistributive spending in the name of social justice.

#### Narrow Margins

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¶4. (S/NF) In the unlikely event that a presidential candidate emerges who champions major economic reforms, rhetoric and practice can be disconnected, according to IRPO business and academic contacts. And business interests that stand to lose as a result of reforms are often compensated in other ways that blunt the effects of reform. For example, Tehran unified its two separate official exchange rates for its currency in 2002, a reform that eliminated a preferential export rate that was a costly and disastrous policy, according to an Iranian contact who is an Ivy-League educated Professor of Economics at the American University of Sharjah in the UAE (please protect).

¶5. (S/NF) At the same time as the IRIG was reforming exchange rates, it also began an export rewards program, commonly referred to as a rebate system by Dubai-based Iranian businessmen. The net result was that exporters who lost a favorable exchange rate under the reform were compensated through a different method. Under this system, rebates based on the value of the goods are offered to exporters, with industrial products receiving the largest rebate of 3 percent, and agricultural and handiwork products receiving smaller rebates, according to Hassan Kabiri, a scion of a prominent bazaari family and managing director/owner of Paknam, one of Iran's largest producers of detergent powder. Multiple IRPO contacts

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also reported that the rebates program is open to abuse and manipulation to favor regime insiders.

¶6. (S/NF) The importance of the rebate and hard currency programs to a company's bottom line is tied to the firms' dependence on export markets. A separate Dubai-based contact who runs an adhesive factory in Tehran and exports his products to Iraq and Central Asian countries described the rebates as crucial to the competitiveness of his products and his firm's success, and they are a much more important factor to his business viability than international sanctions against Iran. And while the government has tried to compensate exporters, producers selling to the domestic market have suffered from muddled government attempts at reform. For Kabiri, whose market for detergent is primarily domestic, the export rebate is not a critical issue, and he is not actively pursuing USD 1.3 million in rebates the government owes him because the paperwork is too much of a burden. For him, the most important government interventions have been consumer price subsidies on detergent, and the tariff rate on imported detergent, both of which have been manipulated to his disadvantage in the past year. IRPO contacts could not gauge the extent to which the rebate and hard currency programs have replaced the former system of multiple exchange rates, but their existence shows how resistant the Iranian economy is to reform.

#### The Price of Success

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¶17. (S/NF) A second example of economic innovation being stifled has been the seizures of promising private enterprises by the IRGC. Iran's small and medium size enterprises (SMEs) could be an agent for reform by creating jobs and being a force for innovation, and one study by an academic at Yazd University of 11,000 SMEs showed that 10 percent of Iran's SMEs created over 70 percent of the jobs in that sector. However, the fear of becoming too successful and attracting the attention of the IRGC, and then being seized by the IRGC or its affiliated companies, has constrained multiple IRPO contacts -- representing the frozen fish, paper, and adhesive industries -- from growing their successful businesses to the extent they could. Entrepreneurs are frequently labeled "fraudsters," according to an IRPO contact who had a paper factory seized by the IRGC.

¶18. (S/NF) The saga of the adhesive producer illustrates how a government seizure has stifled private enterprise. The IRPO contact acquired a small adhesives workshop from an elderly couple, who were experts in their industry, but who had failed to grow the business because of their communist ideology. By introducing Western business practices, improving product quality, and introducing innovative products, the IRPO contact has built up the business, but he has made the decision to limit its growth based on his past experiences. He was formerly the manager of a company that imported U.S.-origin cigarettes into Iran, a business he rapidly built to a level where it employed more than 1,000 people. Eventually the government took notice of this business, and after Ahmadinejad was elected, it seized his import license and handed the business to allies of Ahmadinejad, who were probably IRGC-affiliated, according to the businessman. None of our contacts could gauge how many jobs or other economic benefits the fear of IRGC seizure has cost the Iranian economy, but any reforms that focus on Iran's private sector will first have to establish the rule of law to overcome the fear of IRGC takeovers.

Comment

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¶19. (S/NF) Iran's economic shortcomings receive much attention, but the policy debate we have seen at this stage of the presidential contest has only been on the margins of Iran's legacy of state control of economic activity. The experiences of the Dubai-based Iranian businessmen show that even if economic conditions lead to Ahmadinejad's defeat in June,

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significant reforms to Iran's economy are unlikely in the near term. We are interested whether any of the candidates will claim ownership of Iran's gasoline rationing program (implemented in June 2007), an example of an effort to reign in Iran's massive energy subsidies that has met with some success, as a gauge of their appetite for difficult reforms. Economic problems will more likely simply be the issues that candidates use to attack their rivals.  
RICHARDSON